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August 28, 2003

Mary Cottrell, Secretary
Department of Telecommunications and Energy
One South Station
Boston, Massachusetts 02110

Re: Cambridge Electric Light Company, Commonwealth Electric Company, Boston Edison Company, NSTAR Gas Company, d/b/a NSTAR, D.T.E. 03-47

Dear Secretary Cottrell:

Enclosed for filing, please find the **Redacted Version** of the Reply Brief of the Attorney General. Thank you for your assistance.

Sincerely,

Edward G. Bohlen
Alexander Cochis
Assistant Attorneys General

cc: Service List (redacted version)

Redacted Version

COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Cambridge Electric Light Company,	)	
Commonwealth Electric Company, Boston Edison Company,	)	**D.T.E. 03-47**
NSTAR Gas Company, d/b/a NSTAR	)	
	)	

REPLY BRIEF OF THE ATTORNEY GENERAL

Respectfully submitted,

TOM REILLY
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I. SUMMARY

NSTAR argues in its initial brief that the Department should approve its proposed reconciling pension adjustment mechanism ("PAM") for pension and post-retirement benefits other than pensions ("PBOPS"). NSTAR claims that the PAM is necessary to avoid financial impairment, mitigate volatility in pension expense that NSTAR cannot control, and avoid unnecessary rate cases. The Department should reject each of NSTAR's arguments because they are incorrect and unsupported by persuasive record evidence.[1]

II. ARGUMENT

A. NSTAR Distorts The Standard of Review For Adopting A Reconciling Mechanism For Non-Fuel O&M Items.

NSTAR claims that the factors the Department considers in determining whether to adopt a reconciling mechanism for recovery of an expense category include: (1) the financial impact of the expense on the company (including the size and volatility of the cost); (2) the degree to which the Company can control the cost category; and (3) whether a separate adjustment clause would avoid unnecessary general rate cases. Co. I. Br., at 24. NSTAR notes that "[t]he establishment of reconciliation mechanisms is not a new concept in utility regulation or for the Department." Co. I. Br., at 22. While it is true that reconciling clauses are not new, NSTAR distorts Department standards for adopting a reconciling mechanism for non-fuel O&M items by

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[1] The Attorney General files this Reply Brief for the limited purpose of responding to certain positions taken in the Initial Briefs filed by other parties in this proceeding. This Reply Brief is not intended to respond to every argument made or position taken. Rather, it is intended to respond only to the extent necessary to assist the Department's deliberations, *i.e.,* to provide further information, to correct misstatements or misinterpretations, or to provide omitted context. Therefore, silence in regard to any particular argument, assertion of fact, or statement of position in the various Initial Briefs should not be interpreted, construed, or treated as assent, acquiescence or agreement with such argument, assertion or position.

ignoring important factual distinctions, taking *dicta* out of context, and misrepresenting the Attorney General's position.

NSTAR's alleged standard of review ignores the important distinction between fuel and non-fuel O&M expenses. Two of the four cases cited by NSTAR involve fuel clauses. *Consumers Organization For Fair Energy Equity, Inc.* v. D.P.U., 368 Mass. 599 (1975); *Worcester Gas Light Company*, 9 P.U.R. 3d 152 (1955). Fuel costs are clearly "significant" in relation to total cost of service, constituting up to half of total costs in many instances. Individual non-fuel items such as pensions and PBOPs clearly are less significant. NSTAR has not shown here that pensions and PBOPs are significant. Exh. AG-2 at 5. Fuel prices are clearly volatile. *See, e.g.*, the change in natural gas costs during the past year, Department website: http://www.state.ma.us/dpu/gas/cgac_page.htm. NSTAR has not presented any data or analysis showing that pensions and PBOPs costs for ratemaking purposes (not to be confused with expense accruals for accounting and balance sheet purposes)[2] are so volatile that NSTAR will suffer financial impairment without a reconciling mechanism. Exh. AG-2 at 5-6.

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[2] Utility complaints about volatility and requests to base rate recovery on pension expenses are not new. Fourteen years ago, one Massachusetts utility indicated that its "actuary also stated that there will be cycles of two to three years where booked expense will exceed contributions and vice versa." The Department refused to base rates on pension expense, noting "that the Company's adjustments are essentially based on the estimates and opinions of its actuary. These estimates are subject to considerable variation as circumstances change." *Western Massachusetts Electric Company*, D.P.U. 88-250, at 70, 72-73 (1989). The Department made a similar point recently regarding PBOPs, noting that it:

> has held that financial accounting standards do not automatically dictate ratemaking treatment. D.P.U. 94-50, at 436; D.P.U. 92-78, at 79; D.P.U. 89-81, at 33; D.P.U. 85-270, at 118-119. The Department is charged with setting just and reasonable rates for companies within our jurisdiction, and we cannot permit accounting standards alone to determine our treatment of expenses.

Fitchburg Gas And Electric Light Company, D.T.E. 02-24/35 at 115 (2002).

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NSTAR quotes out of context *dicta* from the Supreme Judicial Court regarding "the main historic purpose of cost adjustment clauses as conventionally stated." *Consumers Organization For Fair Energy Equity, Inc.* v. D.P.U., 368 Mass. 599, 606 (1975); Co. I. Br. at 22. Contrary to what NSTAR implies, the Court did not order the Department, in reviewing a proposed reconciling clause, to consider as factors either avoiding rate cases or the degree of company control over a cost category. NSTAR also ignores the historical context; the Court issued its *dicta* about "notoriously slow" rate proceedings in a time of high inflation and oil price volatility, before the Legislature reduced the statutory suspension period for rate case investigations from ten months to six. G.L. c. 25, §18.

NSTAR also misrepresents the Attorney General's position in a previous Department proceeding, suggesting that he endorsed recovering base rate items in reconciling clauses if they are significant, volatile and substantially not within the utility's control. Co. I. Br. at 22-23, citing *Bay State Gas Company*, D.P.U. 94-16 at 41 (1994). To the contrary, in that case, the Attorney General **opposed** shifting non-fuel O&M costs (contracting, outside services and computer system costs) from base rates to the reconciling CGAC. The Attorney General opposed that shift for many of the same reasons he now opposes reconciling pensions and PBOPs, because it (1) constituted single-issue ratemaking; (2) reduced risk to the company without reflecting the resulting reduction in the cost of equity; (3) reduced companies' incentives to contain costs; (4) enabled companies to collect twice, absent a commensurate reduction to base rates; (5) had not been shown to be significant relative to the total cost of service; and (6) allowed reconciling recovery of costs that more appropriately belong in base rates. *Bay State*

Gas Company, D.P.U. 94-16 at 40-41 (1994); Exh. AG-2 at 5-7, 10. NSTAR's Initial Brief failed to inform the Department that the case rejected the adoption of a reconciling clause for non-fuel O&M. The Department found that "the only appropriate forum in which to investigate the reasonableness of these expenses is a general rate proceeding." *Id.* At 47.

None of the four cases NSTAR cites for adoption of a reconciling clause involves a traditional base rate non-fuel O&M item similar to pensions and PBOPS.[3] The only non-fuel case that NSTAR cited where the Department allowed a reconciling clause involved a unique item, manufactured gas site environmental cleanup costs, that involves public safety. *Manufactured Gas Site Cleanup*, D.P.U. 89-161, at 52 (1990). NSTAR has not shown that pensions and PBOPs are so much more volatile and significant than any other category of non-fuel O&M that a special mechanism is justified. Exh. AG-2, at 5-6.

B. The Department Should Not Approve The PAM Where NSTAR Alleges, But Has Not Proved, That Its Proposal Is Necessary To Avoid Financial Impairment.

NSTAR claims that the Companies and their customers will face detrimental financial consequences if the Department does not approve the PAM. Co. I. Br. at 24-25. NSTAR argues that, without the PAM, NSTAR would (1) have to take an extraordinary charge against common equity,[4] (2) be financially impaired, (3) see its bond rating lowered, (4) have its access to capital limited, and (5) see its stock price drop. Co. I. Br. at 24-27.

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[3] *Consumers Organization For Fair Energy Equity, Inc.* v. D.P.U., 368 Mass. 599, 606 (1975); *Bay State Gas Company*, D.P.U. 94-16 at 41 (1994); *Worcester Gas Light Company*, 9 P.U.R. 3d 152 (1955); and *Manufactured Gas Site Cleanup*, D.P.U. 89-161, at 52 (1990).

[4] One of NSTAR's own witnesses testified, however, more correctly that a charge to equity would be required only if NSTAR does not file a full rate case and it is determined that deferred costs are not probable of recovery under Paragraph 9 of SFAS 71. Exh. PwC-RJS, p. 6.

The Department is not responsible for protecting NSTAR shareholders from a charge to equity or a drop in its stock price, except when those would adversely affect the public interest. *See Lowell Gas Light Company v. D.P.U.*, 319 Mass. 46, 52 (1946)("the function of the department is the protection of public interests and not the promotion of private interests"). NSTAR has not proved that it will suffer financial impairment that would harm ratepayers without the PAM. Attorney General Initial Brief at 12-13. The record instead shows that it is unlikely that any financial impairment that would harm ratepayers will occur. Exh. AG-1; Exh. AG-2 at 5-6,9; Exh. AG 1-47; Tr. 1 at 32, 35, 70.

C. The Department Should Not Approve The PAM In Hopes Of Avoiding NSTAR Rate Cases That May Occur Anyway, May Be Appropriate After Ten Years, And May Show Substantial Merger Savings.

NSTAR argues that the Department should approve the PAM to avoid a series of "unnecessary general rate cases." Co. I. Br. at 29-30. NSTAR's threat should have no bearing on the Department's decision in this case.

Even with approval of the PAM, NSTAR may file a series of general rate cases, and the Department or the Attorney General may initiate general rate reviews. G.L. c.164, §§93 and 94. No one can predict when future earnings will rise or fall enough to necessitate a rate review. Furthermore, the creation of a reconciling mechanism for a cost like pensions might actually increase the likelihood of future rate cases. When the Company does not contribute to the pension fund due to strengthening stock and bond markets, as in the late 1990's, the amounts recovered in rates for this cost can offset increases to other Company costs. This balancing dynamic is at the heart of cost of service ratemaking, and would be lost for pension costs under

NSTAR's proposal.

The Department has not conducted a general rate case review for any of the NSTAR companies in over ten years. *Cambridge Electric Light Company,* D.P.U. 92-250 (1993); *Boston Edison Company*, D.P.U. 92-92 (1992); *Commonwealth Gas Company*, D.P.U. 91-60 (1991); *Commonwealth Electric Company,* D.P.U. 89-114/90-331/91-80 Phase One, (1991). General rate reviews would help ensure that rates reflect recent costs.

The Company describes the calculated earned return on common equity of 14.0% as a "meaningless number" because "[a] revenue deficiency or excess, as computed by the Department for regulatory purposes, is the return on rate base." Co. I. Br., p, 30. The Attorney General disagrees.[5] A revenue deficiency is the additional revenue necessary for the Company to earn the authorized return on rate base. If a Company is earning excess revenue, as a matter of definition, the excess revenue will produce an excess return on common equity. The Company did not dispute the return on common equity of 14.0% calculated by Mr. Effron. This return on equity is well in excess of what the Department would authorize under present conditions and is clearly indicative of excess revenue, any increase in pension costs notwithstanding. Exh. AG-2, p.8.

NSTAR will soon be filing a report on merger savings, which it projected to be hundreds of millions of dollars at the time of the merger. *NSTAR*, D.T.E. 99-19, p. 86. This report may indicate that general rate cases are needed to bring rates down to recent costs.

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[5] Notwithstanding NSTAR's claim that the earned return on common equity is meaningless, it should be noted that the Department uses this calculation for Companies with Performance Based Ratemaking to protect both the customers and "Company from potential earnings losses. . . ." *Boston Gas Company*, D.P.U. 96-50, pp. 325-326 (Phase 1) 1996.

For these reasons, the Department should not approve the PAM in hopes of avoiding NSTAR rate cases.

D. The Department Should Assign Weight To Mr. Effron's Testimony As An Independent Experienced Expert In Utility Accounting And Ratemaking.

The Company spends a considerable portion of its brief discussing the auditing experience of the Attorney General's witness, Mr. David Effron.[6] The Department has accepted and relied on Mr. Effron's testimony in many cases over the past fifteen years. His credentials as an expert witness on utility regulatory accounting and ratemaking issues for over twenty five years were unchallenged. He demonstrated ample understanding of the pension and related accounting rules to render an opinion on these issues. Unlike the Company's witness from PricewaterhouseCoopers ("PwC"), who lacks experience on utility regulatory accounting and ratemaking issues and stated unequivocally that he was not providing any expert opinion but only a "view", Mr. Effron provided testimony without such limitations.

E. The Department Should Assign No Weight To PwC's Alleged "View;" Its Witness Did Not Provide Expert Opinion.

The Company relies heavily on the testimony of Mr. Robert J. Spear, an engagement partner from PwC, to support its request for a pension reconciliation mechanism. Mr. Spear, however, repeatedly testified that he was **not** providing an expert opinion, Tr. 1, pp.107-108, 113 *referencing* Exh. PwC-RJS-3, p. 4, line 25, 175-176, 187. Mr. Spear also stated that he was **not** appearing on behalf of NSTAR as an advocate for the Company's position, since SEC

[6] Much of NSTAR's discussion relates to a hypothetical question that is not relevant to the outcome in this proceeding--whether the Company would have been required to take a charge to equity if the Department had not approved the accounting deferral in D.T.E. 02-78.

regulations would be prohibit that. Tr. 1, pp. 117, 175-176. Mr. Spear even claimed that he was **not** appearing in this proceeding as a consultant for NSTAR. Tr. 1, pp. 175-176, 187.

No specific engagement letter defined Mr. Spear's participation in the proceeding before the Department. Tr. 1, pp. 186-187. The "engagement letter" PwC offered during discovery was really just a separate bill for his services in connection with this case. There is no document specifically defining the scope of Mr. Spear's services, Exh. AG 2-8, although Mr. Spear testified that PwC does **not** provide opinions to major utilities like NSTAR without an engagement letter, and that those letters define the scope of services provided to the utility. Tr. 1, p. 94. The general engagement letters filed in response to a record request covered the annual audit and other services, and made it clear that the services provided by PwC [

Confidential] RR-AG-2 (confidential); *see, e.g.,* confidential PwC letter dated April 14, 2003.

Mr. Spear's "view" is so qualified and limited that it is not useful. Mr. Spear's clients are primarily non-profit organizations; he has almost no experience in regulated utility accounting or ratemaking. Tr. 1, pp.97-100. He admitted that PwC was not expressing an opinion that the proposed adjustment mechanism is the only way for NSTAR to avoid a charge to equity. Tr. 1, p, 118; Exh. PwC-RJS, p. 6.

Mr. Spear makes an unsubstantiated claim that "we would expect something in the range of three to five" years as the "reasonable time" required for recovery of deferred amounts to avoid a write-off under FAS 71. Tr. 1, pp. 119-121, 137-141. That claim, which was not in his pre-filed testimony (Exh. PwC-RJS, p. 6), conflicts not only with Mr. Effron's testimony, but

also with PwC internal e-mails from a more senior partner who has knowledge and experience in the regulated utility industry that Mr. Spear lacks. Tr. 1, pp. 119-121, 137-141; Exh. AG-2-6, Attachment, e-mails from Randall Vitray dated December 3 and 30, 2002.

The Company clearly wishes to capitalize on the reputation of PwC, but the mere appearance of an audit partner in this proceeding to advocate for the Company's position does not provide any evidence to support the Company's position or on which the Department should rely.

III. CONCLUSION

The Department should reject NSTAR's proposed pension adjustment mechanism for the reasons stated above.

Respectfully submitted,

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